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# Public Policy Brief

## Safeguarding Social Security

The Challenge of Financing  
the Baby Boom's Retirement

*Walter M. Cadette*

No. 34, 1997

LEVY INSTITUTE

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# Summary

Social Security—the nation’s largest tax-and-transfer program—faces an uncertain future as the baby boom generation approaches retirement. Funding a large generation’s pensions out of a small generation’s taxes poses a formidable challenge. The system is now building reserves—which are automatically invested in special-issue Treasury securities and thus finance much of the rest of government—but these reserves will not be sufficient to finance future promised benefits. Taxes will have to be raised, benefits trimmed, or reserves invested in assets that render higher returns than those expected from Treasury issues.

In this brief Senior Fellow Walter M. Cadette compares two opposing visions for Social Security’s future. One would keep the system much as it is today: a defined-benefits plan providing a base level of support to all in retirement. The other would “privatize” it, grafting onto it a defined-contribution plan much like a 401(k) and shrinking its public benefits. These are basically the two approaches sketched in the report of the 1994–1996 Advisory Council on Social Security released earlier this year.

Cadette concludes that, on balance, the nation would be better off keeping Social Security much as it is today; despite troublesome demographics, the system can be put on sound financial footing for decades to come with relatively minor changes in tax rates and benefits formulas. Such changes would yield enough additional reserves to tide the system over what otherwise would be large shortfalls in income after 2030. Although he does not necessarily endorse the specific measures advanced by those on the advisory council who would keep Social Security much as it is today, Cadette feels that the group is right in stressing that radical revamping is not needed to remedy the system’s long-term financial problems. Whatever privatization’s advantages may be, they are a poor substitute for the benefit Social Security has offered the nation since the 1930s: a guaranteed base level of income support for virtually all retiring workers. Privatization would involve risk for the vast number of people who have no “private” pension and, by tying retirement benefits to each worker’s own investments, would circumscribe the capacity of the system to subsidize benefits to low-income retirees—ironically, at the very time net benefits must become more progressive than they were in the past.

Cadette raises the question of whether, even if privatization would add to the returns Social Security contributions can provide to beneficiaries at large, government has any interest in seeing to it that Social Security beneficiaries receive more than a socially acceptable base level of support in retirement. Privatization implies that it does and would require that government collect what would still have to be labeled taxes to ensure that the interest is met. The higher returns on “privatized” Social Security taxes, moreover, would be at the expense of lower returns received by other claimants on the income financial capital can provide. Privatization, it is true, would raise national saving, but that is only because it would raise taxes to make good on the existing commitments of the system—a necessity given the dedication of much of future Social Security revenue to individually owned and managed accounts.

If the choice is made to keep Social Security much as it is, Cadette recommends additional income tax incentives to promote saving on the grounds that they would make for faster growth of the capital stock and productivity and thus ease the transfer of income from a relatively small to a relatively large generation. Saving incentives would also help soften the unpopular measures that will be needed to right the system’s long-term financial imbalance (currently estimated at 2.2 percent of taxable payroll). Any reduction in benefits or increase in taxes to remedy the imbalance will require difficult and explicit trade-offs. Serious national dialogue about those trade-offs should have begun long ago. The demographics, after all, are hardly news. If today’s remedy is just over 2 percent of taxable payroll, tomorrow’s perforce will be higher, and the trade-offs will be all the more painful to make. Hard decisions will also have to be made if policymakers strive to improve the equity and efficiency of the system, which also are in need of repair.

The challenge to Social Security is twofold: to bring the system into long-run financial balance while preserving its popularity and to set a course for the system that is in balance with all the other obligations of government. Support of the elderly and the near-elderly under Social Security and publicly financed health care programs already requires an overall tax rate approaching 10 percent of GDP; government’s ability to meet all its obligations will be even more in question over the next decades than it is now.

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# Preface

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The aging of the baby boom generation poses challenges for the nation's Social Security system. Baby boomers on the verge of retirement and younger workers thinking about their future are questioning the ability of the system to provide them with the same level of benefits their parents enjoyed.

Thus far, the system has been able to maintain itself and has even built up sizable reserves, mainly because of the increasing income and productivity of each succeeding generation in a growing economy. Although commonly thought of by the American public as a system in which retiring workers receive as benefits the money they paid into it, in truth Social Security has always been pay-as-you-go. The payroll taxes levied on the workers of today are not "saved" for those workers' retirement, but are paid out as benefits to the current retirees. But the system's financial security will soon face a demographic challenge brought about by increased longevity, lower birthrates, and the population bulge of the baby boom. Thirty years ago the ratio of workers to retirees was 4 to 1, today it is 3 to 1, and by 2030 it is expected to be 2 to 1. It is possible that tomorrow's workers will not be able to support tomorrow's retirees.

Concern about safeguarding Social Security's future has led policymakers and the public to consider alternative plans for keeping funding and benefits in balance. One option is to make relatively minor changes in funding methods and benefits while maintaining the system much as it is. The other option is to privatize the system, thus radically changing it.

The gap between rich and poor in the United States has grown. And, as Senior Fellow Walter M. Cadette points out in this Public Policy Brief, even though Social Security has through the years fulfilled its fundamental purpose of assuring a base level of support for all retired workers, some of its provisions have contributed to an inequitable distribution of wealth by transferring wealth from low-wage workers to wealthy retirees. In addressing the issue of Social Security's future, policymakers cannot ignore the broader issues of income inequality in the nation and the equity of the Social Security system.

In this brief Cadette describes the current system, discusses positive and negatives aspects of both options for changing it, and offers some of his own suggestions for putting Social Security on sound financial footing. His goal is to provide readers with the information they will need to understand the issues in what will soon be an important policy debate.

Dimitri B. Papadimitriou

*Executive Director*

September 1997

# The Challenge of Financing the Baby Boom's Retirement

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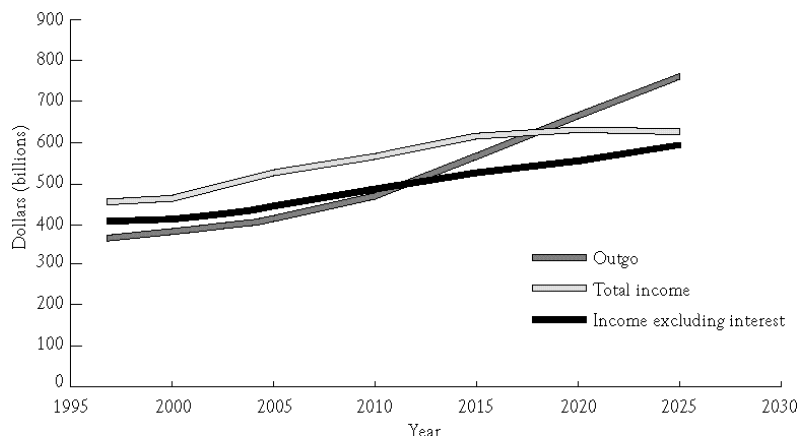
The post–World War II baby boom has left its mark on the American economy in many ways. Nurseries and schools bulged beyond capacity. The labor market could not absorb new entrants without also giving rise to disappointing productivity growth. The relative price of housing soared. And, now, yet another challenge looms: this time for Social Security, as the leading edge of the baby boom approaches retirement. Longevity adds to the problem created by a large generation. Thanks to modern medicine, more people live to retirement age, and they live longer as retirees. As the product of these forces and of the drop in the nation's birthrate after the mid 1960s, an unprecedentedly low ratio of workers to Social Security beneficiaries lies ahead. The ratio fell from as high as 4 to 1 thirty years ago to about 3 to 1 today and is projected to drop to 2 to 1 thirty years from now.

How the demographic challenge is met will profoundly affect not only the Social Security system but the broader budget outcome and the economy at large. Already, Social Security—understood here to encompass the Old-Age (OA), Survivors (S), and Disability (D), but not the Health (H) Insurance (I) parts of OASDHI—accounts for 22 percent of federal spending and 5 percent of gross domestic product (GDP). Within the next several decades the percentages could easily rise by a third and perhaps as much as half.

Although projections that far into the future may fall wide of the mark, even now two things are clear. First, tabloidesque characterizations of Social Security's "going broke" are out of place. The system can maintain benefits for more than 30 years at current tax rates, to judge by the base-case assumptions in the last annual report of its trustees (Social Security



**Figure 1** Estimated Income and Outgo, Based on Intermediate Assumptions, of the Combined OASI and DI Trust Funds in Constant 1997 Dollars



Note: Estimates for later years are not shown because the combined trust funds are estimated to become exhausted in 2029 under the intermediate assumptions.

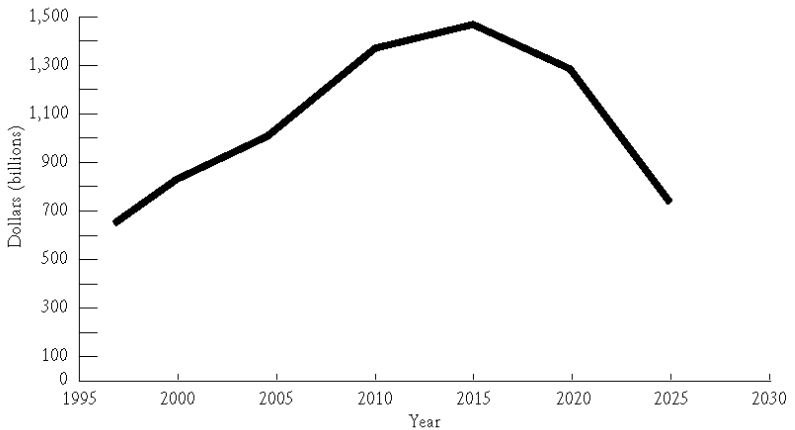
Source: Social Security Administration, *The 1997 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (Washington, D.C.: 1997), Table III.B2.

Administration 1997). Second, even though the system can maintain benefits for several decades, it cannot make good on all of its benefits promises in the longer run without significantly higher payroll taxes (Steuerle and Bakija 1994). After 2030, the trustees project, only three-quarters of benefits can be maintained at current tax rates. And, as early as 2010 benefits will exceed taxes. For a time thereafter reserves (which are held in the form of special-issue Treasury securities) will remain on the rise as interest on them continues to accrue. But reserves will grow less rapidly and will then start to decline as benefits continue to exceed taxes (see Figures 1 and 2).

## Differing Models for the Future

One of two visions of Social Security's future would keep the system much as it is today, but tailor benefits formulas and taxation to the new demographic exigencies. The other would "privatize" it, grafting onto the system a defined-contribution plan much like a 401(k) and shrinking its public benefits. These are the main lines of the two competing approaches sketched in the report of the Advisory Council on Social Security (1997) released earlier this year.<sup>1</sup>

**Figure 2** Estimated Assets, Based on Intermediate Assumptions, of the Combined OASI and DI Trust Funds in Constant 1997 Dollars



Note: Estimates for later years are not shown because the combined trust funds are estimated to become exhausted in 2029 under the intermediate assumptions.

Source: Social Security Administration, *The 1997 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (Washington, D.C.: 1997), Table III.B2.

Six of the 13 council members put forth a plan of reductions in benefits and increases in taxes on benefits to eliminate about two-thirds of the long-run actuarial imbalance, which today is estimated at 2.2 percent of taxable payroll (Social Security Administration 1997).<sup>2</sup> They also propose that policymakers consider investing up to 40 percent of system reserves in equities to correct the remaining one-third of the imbalance. Investment in the stock market (on the premise that its relatively high returns will carry over into the future) would limit the program changes that otherwise would be needed.

Investing reserves in the stock market instead of in Treasuries would be a major change in federal finance as a whole, as it would force the Treasury to find private outlets for any federal debt the Social Security trust funds would not purchase.<sup>3</sup> But it would not be a departure for Social Security itself. The risk involved in the system's new investment strategy would be borne publicly and the defined-benefits character of the program would be maintained (hence the label "maintenance of benefits" for this plan). From the perspective of the pensioner and the taxpayer, nothing would have changed.

The privatization alternative, which was supported by five council members, would dedicate 5 percentage points of the current 12.4 percent OASDI tax rate on covered earnings (this year, a maximum of \$65,400) to individually managed personal security accounts. Although such investment would operate under government strictures (regulating, for example, withdrawal of funds before retirement age), the privatized assets would be owned by the individual and could therefore be passed on to heirs.

Another two council members, among them Chairman Edward M. Gramlich, advocated a smaller, but conceptually similar, privatization plan, to be funded by a tax of 1.6 percentage points on top of the 12.4 percent. The Gramlich plan would limit asset choice to a handful of government-approved mutual funds and any privatized assets would have to be annuitized, as Social Security is today. But, like the more ambitious personal security accounts privatization plan, the Gramlich variant moves Social Security away from a defined-benefits plan and in the direction of a defined-contribution plan.

### **Nature of the Choice**

This brief compares the two visions of Social Security's future. (It does not consider in any detail the Gramlich plan, as it is an amalgam of the two.) Its object is to give readers the background they need to understand the arguments made by both sides and thus to follow the debate on privatization that promises to unfold at the national level in the next few years—first, perhaps, in the confines of a presidential commission and later in Congress and the political arena at large. There is no mistaking what is at stake. It ultimately is a choice between a communitarian and an individualistic approach to the economic security of the elderly.

On balance, the nation would be better off keeping Social Security much as it is today. Despite troublesome demographics, the system can be put on sound financial footing for decades to come with relatively minor changes in tax rates or benefits formulas, as indicated by today's relatively small imbalance of 2.2 percent. Such changes would yield enough additional reserves to tide the system over what otherwise would

be large shortfalls in income after 2030. Whether the specific measures advanced by the maintenance of benefits group are the “right” ones is another issue. But, clearly, the group is right in stressing that radical revamping of Social Security is not needed to remedy the system’s long-term financial problems.

Privatization is a poor substitute for the benefit Social Security has offered the nation since the 1930s: a guaranteed base level of income support for virtually all retiring workers, half of whom have no “private” pension. It would create risks that many—because of low income—should not run. Moreover, by tying retirement benefits to each worker’s own investments, privatization would circumscribe the capacity of the system to subsidize benefits to low-income retirees—ironically, at the very time net benefits (that is, the annuity value of benefits over the annuity value of taxes paid in) must become more progressive than they were in the past.

Privatization would add to the returns Social Security contributions can provide to beneficiaries at large, but it is questionable whether that should concern government. Why would government compel people to save as individuals? Does government have any interest in seeing to it that Social Security beneficiaries receive more than a socially acceptable base level of support in retirement? Privatization implies that it does and would have government collect what would still have to be labeled taxes to ensure that the interest is met. The higher returns on “privatized” Social Security taxes, moreover, would be at the expense of lower returns received by other claimants on the income financial capital can provide.

Privatization, it is true, would raise national saving. But that is only because it would raise taxes to make good on the existing commitments of the system—a necessity given the dedication of much of future Social Security revenue to individually owned and managed accounts. Nothing else can be claimed for it.

If, at the end of the day, the choice is to keep Social Security much as it is, additional income tax incentives to promote saving are in order. They would make for faster growth of the capital stock and productivity and thus ease the transfer of income from a relatively small to a relatively large generation. There are, after all, ways to raise national saving other

than through the added taxation privatization would require to be viable. Saving incentives are also in order from the narrow perspective of Social Security itself. They would help to soften the unpopular measures that will be needed to right the system's long-term financial imbalance.

Unpopular those measures are sure to be. A reduction in benefits or increase in payroll taxes, even if just over 2 percent of taxable payroll, will require difficult and explicit trade-offs. Hard decisions will also have to be made if, while policymakers are at it, they strive to improve the equity and efficiency of the system, which also are in need of repair.

Serious national dialogue about those trade-offs should have begun long ago. The demographics, after all, are hardly news. That dialogue has been tabled time and again—the last time during the 1996 presidential campaign—in deference to Social Security's status as an untouchable, if not a "third rail," program. The political establishment's reluctance to confront known problems before they become "crises" is apparently alive and well. If today's remedy is just over 2 percent of taxable payroll, tomorrow's perforce will be higher, and the trade-offs will be all the more painful to make.

The challenge to Social Security is twofold. First is the almost Catch-22 problem of bringing the system into long-run financial balance while preserving its popularity and second is the task of setting a course for the system that is in balance with all the other obligations of government. Support of the elderly and the near-elderly under Social Security and publicly financed health care programs already requires an overall tax rate approaching 10 percent of GDP; it can go only up from there, quite possibly doubling within the next few decades. Government's ability to meet its other obligations will be in question even more than it is now.

The problem of financing Medicare and other government health care programs for the elderly is outside the scope of this paper. Policy decisions with respect to OASDI can be made on their own merits, as can those in the area of health care. Indeed, that is implicit in the separate trust funds established for Old-Age and Survivors Insurance, Disability Insurance, and Health Insurance and in the different payroll taxes that finance OASDI and HI. It must be kept in mind, however, that the demographic forces at work in Social Security retirement also affect

health care programs, the beneficiaries are largely the same, and, not least, the programs draw resources from a common pool.

### **Social Security: Structure and Function**

In order to evaluate the alternative approaches, it is important to understand how benefits are structured, how Social Security affects the broader budget outcome, and how the system transfers income within and across generations.

Benefits are set by a worker's lifetime earnings, adjusted to reflect earnings prevailing in the economy at large about the time of the worker's retirement; they are not set, as the common misconception would have it, by taxes paid. This "bank account" model was fostered by "I paid into it" thinking, a seemingly logical outcome of payroll tax financing. It was also fostered by the political establishment, which did not want the cost of any largesse on the benefits side to be apparent to taxpayers. Taxpayers were encouraged to view their payroll taxes as saving for their own retirement.

Although the system is now building reserves, it is still largely pay-as-you-go. And it was entirely pay-as-you-go through the late 1980s. Each generation, in effect, pays for the retirement of its parents and, in turn, is supported by its children—the essence of a tax-and-transfer system operating across generations. The retiring (older) and working (younger) generations are parents and children writ large in the underlying model of the family (Mehrling 1996). In the traditional family parents' own children assumed the provider role—sometimes successfully and sometimes not. Now, instead, the income of the older generation as a whole depends on the income and productivity of the younger generation, whose success as provider is guaranteed in a growing economy.

From the point of view of the family model, today's emphasis on "money's worth" calculations—in the advisory council's report and in other forums for debating Social Security's future—is overdone. Money's worth is surely a valid consideration, but Social Security is not, and never was, a saving and investment plan; rather, it is, and always was, a way for children to support elderly parents (here writ small) with income

that would have to be provided by the children in most, even if not in all, cases. It is as hard to make reliable money's worth calculations for Social Security as it is to estimate the returns to be derived from paying an aged parent's rent bill.

## **Calculating Benefits**

Benefits are progressive, that is, they are high relative to the lifetime earnings of low-income workers and low relative to the earnings of high-income workers, thus countering the regressivity of a flat payroll tax rate on earnings up to a ceiling. The object is to provide a base level of support in retirement, linked to the living standard most workers (that is, all but those with top earnings) attained during their working life. The object is not to maintain the income of high-income workers, who ordinarily have ample personal and employment-linked retirement resources. Whether those resources are, in fact, ample cannot be a matter of public policy concern.

Benefits are keyed to each worker's average lifetime earnings, adjusted to reflect the economywide wage level just before the worker's retirement. This allows retirees, at least initially, to capture the growth in productivity and thus in real earnings that came about during their working life. Only initial benefits are linked to prevailing wages, however. After retirement, benefits are escalated by inflation, measured by the previous year's rise in the consumer price index (CPI), but they do not increase with real earnings. In short, they keep up with inflation, but not with general living standards.

The calculations for a new retiree start with the history of his or her earnings at age 60. The earnings for each year, up to the taxable wage base for that year, are multiplied by an index factor that reflects the subsequent growth in economywide wages. The resulting series (with earnings after age 60 indexed at a value of one) thus captures what the worker would have earned each year had he or she been working in today's environment of relatively high productivity rather than in the past (see Table 1). From the time series of indexed earnings, the highest 35 years are averaged and then divided by 12 to compute the average indexed monthly earnings (AIME).

**Table 1** Calculating the Pension of an Average Wage Earner Retiring at Age 65 in 1997

5-Year Period Ending	Average Annual Earnings (dollars)	Average Index Factor	Average Indexed Earnings (dollars)
1996	26,500	1.00	26,500
1991	21,800	1.14	24,855
1986	17,300	1.43	24,739
1981	13,800	1.97	27,186
1976	9,200	2.82	25,944
1971	6,500	3.91	25,415
1966	5,000	5.02	25,100

Note: The highest 35 years of indexed earnings average \$25,677, which divided by 12 gives an average indexed monthly earnings (AIME) of \$2,140. The calculations are done in the table as five-year averages to simplify and shorten the table. The actual calculations are done for each year. The premise is that none of the highest 35 years of earnings came before 1962.

The next step is to compute the primary insurance amount (PIA), which is what the worker will receive each month at retirement if he or she retires at the normal retirement age of 65. The PIA is calculated by dividing the AIME into three parts, multiplying each part by successively lower percentages, and summing the resulting dollar amounts. The three amounts to be summed are 90 percent of \$422, the first AIME “bend point” for 1994 (which is when someone now age 65 turned 62); 32 percent of the next \$2,123; and 15 percent of the amount in excess of \$2,545. The PIA is then adjusted for retirement age within the range of –20 percent (for those retiring as early as age 62) to +25 percent (for those willing to wait until age 70). These percentages are slated to change slightly in the future to provide a premium of 8 percent per year for postponing retirement—the object being to structure an age-neutral annuity for those retiring at 62, at 70, or at any age in between. The actuarially fair value of lifetime benefits will be the same for all, theoretically rendering the normal retirement age of 65 (or 67 as current law would have it rise to over time) almost meaningless.

A “spousal benefit,” equal to 50 percent of the retiring worker’s PIA, is also factored in, even if the spouse never worked. Both members of a two-wage couple receive benefits in their own right, but, at a minimum, the lower earner of the two is entitled to the spousal benefit attaching to the higher earner’s pension. Benefits formulas thus favor couples with widely disparate earnings—at the extreme, one-wage couples—which is



no surprise considering the system's roots in the 1930s, when the labor force participation rate of women was far below today's and joblessness abounded.

The bend points, like the AIME, are indexed to prevailing wages. The formulas thus are designed to increase average real benefits for successive cohorts of new retirees at roughly the same rate as economywide wages. The object is to keep replacement rates (the percentage of earnings just before retirement that Social Security replaces) constant over time. The object also is to keep replacement rates constant between one income group and another in every retiring cohort (this comes about because the percentages applying to the AIME amounts below each bend point are fixed). Successively lower percentages at each bend point provide the progressivity.

### **Pattern of Replacement Rates**

Replacement rates are higher today than the historical norm for the majority of retirees (Steuerle and Bakija 1994), but they are in line with outcomes under benefits formulas set out as early as 1939 (Myers 1993). For single workers at age 65, for example, Social Security replaces about 53 percent of earnings just before retirement for those at low wages, about 40 percent for those at average wages. In contrast, today's replacement rates are below the historical norm for high-wage workers. They are in the neighborhood of 26 percent of preretirement earnings close to the maximum wage base (replacement rates decline beyond that base, since only earnings below the base are included in calculating benefits).<sup>4</sup>

Replacement rates today cluster in the range of 10 to 30 percentage points higher than in the early 1950s. At that time, in the absence of adjustment mechanisms that would have seemed unnecessary in the deflationary 1930s, Social Security had failed to keep up with the rise in the price level during and just after World War II. Legislation enacted in 1950 was designed to correct that oversight. But ad hoc changes made in ensuing years, combined with the 1950 measure, had the net effect of lifting real benefits not only for new retirees but for beneficiaries at large—including the nonelderly disabled, who became eligible for benefits for the first time in 1956. A virtual bidding war to raise retirement and other benefits (which at the time were not indexed to inflation but

set by individual pieces of legislation) marked American politics in the late 1960s and early 1970s. Benefits rose an extraordinary 72 percent in the five-year period ending in 1972; real benefits rose by nearly half (the CPI in the five-year period increased 28 percent). All the while, the ratio of workers to retirees, even if high by today's standards, was on the decline.

Replacement rates came down from the peaks they reached in the mid-1970s when a flaw introduced into the calculation of benefits in 1972 was corrected. The bidding war came to an end at the same time with the adoption of automatic escalation of benefits keyed to the CPI. Even so, Social Security outlays had risen roughly 10 times as rapidly as nominal GDP between the early 1950s and the early 1980s. Tax rates had more than tripled, applied against a wage base that relative to prevailing wages had also more than tripled.

### **Watershed 1983**

Payroll taxes took another jump in the 1980s when increases in tax rates legislated in the 1970s were moved forward in order to deal with a looming liquidity problem. OASDI taxes rose in a series of steps from 10.8 percent of covered payroll (employer and employee combined) in 1983 to the current rate of 12.4 percent by 1990. Benefits were reduced at the same time, principally by raising the normal retirement age and by making some benefits taxable (in effect, reducing them). The normal retirement age was slated to rise gradually, beginning in 2003, to age 67 by 2027. Currently, benefits become subject to tax when income exceeds \$32,000 on a joint return (\$25,000 on a single return). At those levels 50 percent of the benefits get taxed, but the percentage quickly rises to 85 percent as other income rises. The exemption amounts are not inflation-indexed and thus decline in real terms over time.

The effect of the changes, even if not the intention, was to build reserves in a period of demographic calm that can be drawn down later when the baby boom generation actually retires. In a pay-as-you-go system, reserves other than for liquidity purposes have no place, but they can play a useful role by smoothing the pattern of taxes over time. In effect, the baby boom generation was to finance not just the retirement of their parents but, through the accumulation of reserves, part of their own as well.

The reserves are now accumulating at an annual rate of \$76 billion; they are projected to grow to \$1.5 trillion in constant 1997 dollars by the peak year 2015 (Social Security Administration 1997). Automatically invested in Treasury issues, Social Security's surplus financed almost 40 percent of the deficit of \$173 billion in the rest of the budget in fiscal year 1996; the OASDI trust funds hold just over 10 percent of gross federal debt.<sup>5</sup>

Critics of these arrangements view the trust funds (and therefore the reserves held in the form of Treasury securities) as a fiction. They view the funds as holding not real securities but merely IOUs of the Treasury generated by deficit financing itself. To make good on those IOUs, the concern is, Washington must raise taxes, cut spending, or float more debt in private markets. Those IOUs, however, are not essentially different from the Treasuries held by private pension funds or individual investors for their own account—not marketable perhaps, but just as “full faith and credit.” They have solid backing in the form of the nation's political will to support the elderly, whether by payroll taxes or other means, and the economic ability to do so (Eisner 1996).

However wide apart in perspective, the two views of the trust funds are similar in implication. Not all that far ahead, Social Security not only will be unable to finance a large part of the rest of the budget, it also will have to lay claim to non-Social Security tax sources. As noted, benefits are projected to exceed payroll taxes by 2010; other revenue will have to supplement payroll taxes in order for the system to pay full benefits for the subsequent 20 years—a time when it will have to, first, draw on the interest on the Treasuries now accumulating in the trust funds and, later, consume the principal as well.

The critical date for Social Security, narrowly considered, is as far off as 2030, but, for the budget at large, it looms as early as 2010. Thereafter, Social Security benefits can be maintained at current tax rates, but only if, in some combination, federal borrowing from the public rises, spending for other federal activities is cut, and taxes are raised. The challenge the nation faces is not only to correct Social Security's long-run financial imbalance, but also to find the revenue to repay the system for the large net lending it will have done for several decades.

## **Typology of System Subsidies**

Social Security's appeal over the years has been grounded in the fact that almost all of its beneficiaries have been "winners." Almost all have secured a retirement annuity significantly greater in present value than the value of the payroll taxes they and their employers jointly "contributed" during their working life, and they have had the assurance that their families would be protected financially in the event of their death or disability before retirement age. Setting benefits on the basis of prevailing wages rather than on the basis of taxes paid, in combination with secular growth in the economy and favorable demographics, almost guaranteed that outcome.

With the sharp rise in Social Security taxes in the 1980s, on top of a similarly sharp rise in the 1970s, all participants are no longer winners. Steuerle and Bakija (1994) have calculated the present or annuity value, in constant dollars, of OASI net income transfers for 23 age cohorts, by family type (e.g., married, one-earner) and by lifetime income level, retiring at five-year intervals between 1940 and 2050.<sup>6</sup> Such a measure captures the redistributive character of the system across and within generations. The findings go a long way to explain why Social Security has been immensely popular over the years but why skepticism, if not cynicism, is growing among young workers. The key findings are:

1. Most retirees thus far have secured positive net income transfers, that is, amounts in excess of the payroll taxes they and their employers paid in, plus a reasonable rate of return. The dollar amounts of the transfers have been the highest to high earners, as the amounts have been figured on a high base. Thanks to progressive benefits formulas, low earners have received the largest percentage return, but this has been on a relatively small base.
2. The largest net transfers went to retirees of the early 1980s. High-income, one-earner families that drew a pension beginning in 1980, for example, received a net subsidy whose annuity value in today's purchasing power was close to \$200,000. These families benefited from the bidding war of the late 1960s and early 1970s, they had paid pre-bidding war taxes for most of their working life, and they did not get hit by the tax hikes of the 1980s.

3. Despite the decline in net subsidies, today's benefits formulas will continue to provide net transfers for many beneficiaries (even if significantly less than for their parents and grandparents)—in particular, one-earner couples, because of spousal benefits, and two-earner couples at low-income levels, because of the progressivity built into benefit formulas.
4. Net subsidies will continue to decline in the future. They have already turned negative for high-income, single people (the major exception to the winner rule thus far), and they will become negative for high-income, two-earner couples around the year 2000.

In all, progressivity will be greatly more important in shaping benefits as the baby boom generation retires. Without another jump in payroll taxes, net subsidies cannot be extended to the vast majority of beneficiaries. Social Security simply cannot serve the interests of young workers—if those interests are measured by money's worth—anything like the way it has served the interests of their parents and, even more, their grandparents. This is not a fault of the system; it is the inevitable result of the shift from favorable to unfavorable demographics.

### **Option 1: Working within the Current Framework**

Those who view Social Security as needing midcourse corrections rather than conceptual change would apply traditional remedies (defined broadly to include equity investment as long as the risks are public and the assets are managed by the government itself). These corrections, they point up, can be much smaller than in other industrial countries, which face even more problematic demographics. Compared with most other developed countries, the United States has less imbalance in its age structure, and its payroll taxes start at much lower levels.

All the same, trade-offs cannot be avoided. And, even if there were already a program in place to remedy the actuarial imbalance of 2.2 percent of taxable payroll, the system would not remain in balance with the passage of time as surplus years get replaced by deficit years and as longevity continues to rise. As an average for the next 75 years, the 2.2 percent figure reflects near balance in the next 25 years, but deficits are

projected to reach almost 4.5 percent in the 25 years ending in 2046 and almost 5.5 percent in the subsequent 25 years.

As with any long-term estimate, the 2.2 percent figure will have to be revised as time passes.<sup>7</sup> It nevertheless serves as a useful standard against which specific proposals can be compared. Measures that would not cut far into the 2.2 percent and that are also apt to be highly objectionable to the public are easy to rule out. Measures that would either offer large savings or that promise relatively little outcry are similarly easy to keep in the running.

Advisory council members who would keep Social Security much as it is today and those who would privatize it, however much they differ in their basic approach, are in accord in counseling against relying on increases in payroll taxes to close the 2.2 percent gap. With money's worth calculations for young workers turning unfavorable, the council was united in the concern that raising payroll taxes further would compromise the individual equity principle that was part of the basic idea from the start.

Cuts in benefits that affect retirees and workers alike (and workers well up in years as well as the young) thus dominate in the proposals of the maintenance of benefits group.<sup>8</sup> The proposals, which are summarized below, would reduce the long-term deficit by 1.4 percentage points—leaving 0.8 percentage points to be eliminated by other, as yet unspecified, benefits or tax measures or by investment of reserves in the stock market, if that makes sense on further inspection.

1. *Cover all state and local government employees (the revenue from the additional payroll taxes net of benefits would reduce the long-term deficit an estimated 0.22 percentage point).* Almost 4 million state and local government employees (about 25 percent) are not now covered (most at the option of their employing governments). There is no justification for not making the system truly universal.
2. *Tax benefits in excess of the payroll taxes retirees paid during their working lives (0.31 percentage point).* Taxing only the employer contribution and the imputed returns from both employer and employee contributions would be in keeping with horizontal tax equity, treating equally the

income of two taxpayers with the same income. Most low-income beneficiaries would be protected by the standard deduction and other defenses in the code for low-income taxpayers. Either in part (as now) or broadly (as proposed), taxation of benefits is an indirect form of means-testing—without, however, the disincentive to save inherent in direct means-testing.

3. *Redirect the income taxes on Social Security benefits from the health insurance trust fund to the OASDI trust funds (0.31 percentage point).*<sup>9</sup> There is no logic for attributing much of the revenue from taxes on benefits to HI. However technical, the issue of where to lodge this revenue points up the nexus between Medicare's and Social Security's financial problems.<sup>10</sup>
4. *Reflect changes incorporated in the CPI in 1996 by the Bureau of Labor Statistics (0.31 percentage point).* Out of concern for the integrity of the computations, all council members opposed making any legislative change in cost-of-living adjustments.
5. *Compute the AIME using 38 years, instead of 35 (0.28 percentage points).*<sup>11</sup> A change of this nature would reduce benefits for future beneficiaries by about 3 percent. One member of the group opposed it as unfair to women, who typically spend several years out of the work force bringing up their children.

## Closing the Gap on the Benefits Side

The maintenance of benefits group selected proposals from an array of possible actions, all of which carry pluses and minuses, both substantive and political. The broad public policy issue is which of Social Security's potentially conflicting goals—individual equity (which is reflected in the use of lifetime earnings to set benefits) and social adequacy (which is reflected in progressive benefits)—should get more emphasis in a setting of greater potential clash between the two than ever before.

Three changes in particular have merit: raising the retirement age, reducing benefits to high-income retirees (directly as well as indirectly through the taxation of benefits), and raising survivor benefits. None of

them would alter the system in a fundamental way, and they all would resolve the potential clash in the direction of social adequacy.

The retirement age has to be reexamined against a background of increasing longevity. In 1940 average life expectancy at age 20 was 67 for men and 70 for women. Today it is 74 for men and 80 for women, and it is projected to rise another two years by 2020. Today a man who reaches age 65 can expect to celebrate his 80th birthday and a woman will see her 84th birthday—three and five years longer, respectively, than when Social Security was first established with a normal retirement age of 65.

One proposal, advocated by many students of Social Security, would be to lift the normal retirement age to 68 (once it hits the already scheduled rise to 67) and then index it to life expectancy. Indexing would maintain the relationship between working and retirement years—and thereby add a stability feature to the system it now lacks.

Today, retiring in the early 60s, or even at age 65, means spending almost a third of one's adult life as a retiree. Is that the product of institutional arrangements, like Social Security, that date from the 1930s and that are distinctly less relevant now? And do these arrangements make even less sense because the ratio of workers to retirees is to fall to unprecedentedly low levels?

The ramifications of leaving the retirement age untouched as life expectancy increases are far-reaching. Making a living that has to be stretched over ever longer retirement means longer work weeks, less vacation, and more stress—indeed, a concentration of work effort that can take an unhealthy toll on individuals and on society at large (Steuerle, personal communication 1997). Workers are not willing to accept a lowering of compensation as their productivity declines with age, and employers are reluctant to lower compensation when productivity declines, partly because they fear an accusation of ageism in a society that is increasingly litigious over group rights (Thompson, personal communication 1997); employers opt instead to force retirement, even if they have to sweeten it with “packages.”<sup>12</sup>

The point is often made that raising the retirement age hurts manual workers and others, like firefighters, with physically demanding jobs. It would be imprudent, however, to structure rules for a universal system



for a small part of the population. It is the function of the disability part of Social Security, not the retirement part, to support the incomes of people unable to work.

One danger (which the 1983 legislation succumbed to) is to increase the normal retirement age (from 65) without increasing the early retirement age (from 62). Even with an annuity structured to be neutral with respect to age of retirement, many will opt for early retirement, especially with employers shedding workers in their late 50s and early 60s. As the normal retirement age rises to 67 in coming years, early retirees will pay even higher penalties in the form of reduced pensions, which years later will yield an even higher poverty rate among the so-called old-old (those 85 and over).

Significant economies could accrue from relatively small changes in benefits formulas that affect high-income workers, for example, lowering the 15 percent factor used to compute the PIA or adding a fourth percentage factor (of, say, 10 percent) at top AIME levels.

Lowering the top end of benefits (along with added income taxation of benefits) would reduce the redistribution of income from many poor workers to many well-heeled retirees—a feature of the system that has been widely criticized (Peterson 1996). And it would make the system more progressive in benefits at a time when it cannot possibly subsidize almost all participants as in the past. The degree of progressivity, to be sure, is a matter of political choice, but one thing surely speaks in favor of adding to it: decades of growing inequality in the distribution of wages and salaries, an inequality echoed in the personal savings for retirement that people are able to amass during their working years. Increased progressivity would also counteract the loss of pension benefits many low-wage workers have incurred as their jobs have been “outsourced.”

The goal of individual equity itself needs to be examined in light of changing conditions. The 50 percent spousal benefit may have made sense in Social Security’s early days, but it has led to the anomaly of relatively high pensions for many couples at already high income levels. Survivor benefits, in contrast, are often too low to prevent many elderly (especially the old-old) from slipping below the poverty line when a spouse dies. The survivor gets the higher of (a) his or her own benefit or

(b) his or her spouse's benefit, but that means a relatively large loss of income for the survivor whose earnings and whose spouse's earnings were of the same order of magnitude. Now that women are fully represented in the labor force and because they tend to outlive their husbands, they in particular face such a drop in income. As many as 30 percent of women over the age of 80 who live alone fall below the federal poverty line, with the percentage rising sharply as age increases (Moon 1997). "Until that problem is addressed, Social Security is less than a success," according to former commissioner Robert M. Ball, one of the system's otherwise strongest apologists (personal communication 1997).

### **Closing the Gap on the Tax Side**

Once almost invisible, Social Security taxes are now higher for most middle-income Americans than are income taxes, at least if the employer contribution is included in the count as income that workers otherwise would receive. The money's worth issue for young workers, who would be disproportionately affected by a further rise in payroll taxes, bears repeating, and so does the concern that the system transfers income from low-income workers to high-income retirees. Any increase in Social Security taxes, moreover, will crowd out the taxes needed to right Medicare's long-term financial imbalance. Medicare can close much of its financing gap on the spending side, although surely not all of it without radical reduction in the scope of the program.

Advocates of closing the 2.2 percent gap on the tax side point out that the needed increases in revenue are small in the context of a growing economy. Baker (1996 and personal communication 1997), for example, calculates that a series of additions to payroll taxes of 0.1 percent per year in the 36 years ending in 2046 (for a total of 3.6 percent) would eliminate the long-term deficit. And all that such additions would do is reduce the growth of real after-tax wages from, say, 1.0 percent to 0.9 percent per year; the level of real after-tax wages would still be half again as high as it is now. Adding over 3 percentage points to the OASDI payroll tax (and presumably at least several percentage points more for HI) is almost certain, however, to threaten the financing of the rest of government. The higher the tax rate, moreover, the harder issues of intergenerational equity are to resolve. That the tax rate will have risen

slowly over decades will be small comfort to the workers of 2046, none of whom would have had a voice in setting the rate.

Several changes in taxation nevertheless are justified.

1. Because of the trend toward increased inequality in earned income, covered wages have slipped as a percent of total wages, falling from 90 percent in 1980 to 88 percent today (Kingson 1996), and they are headed lower still as the distribution of income at the top apparently continues to widen. A one-time adjustment in the wage base of, say, 2 percentage points would only return the covered share of earned income to historical norms.
2. Including employer-provided health and life insurance benefits in covered earnings would promote tax equity between those who pay for health care and life insurance mostly out of before-tax income (because those benefits are linked to their jobs) and those who lack such benefits and thus pay for coverage largely out of after-tax income.<sup>13</sup> Including health care benefits, or only including those above the norm, would yield economies in health care that are now blocked by excessively favorable tax treatment of those benefits—a plus for Medicare even if not for Social Security itself (Cadette 1997).

## **Option 2: Privatization**

Privatization would split Social Security into two parts: a forced saving and investment plan, with returns varying with market performance, and a basic payment (tied only to number of years at work), which all beneficiaries would receive. For each beneficiary 5 percentage points of the current 12.4 percent Social Security tax rate would be devoted to an individually managed personal security account, similar to a 401(k) account and open to a wide range of investment vehicles, including equities. The remaining 7.4 percent percentage points would fund the basic payment and nonretirement benefits such as disability.

An important point to stress is that it is not investment in the stock market that distinguishes privatization plans. In that respect, the plans

are no different in any fundamental sense from plans to have government invest system reserves in the stock market. The distinguishing feature is individual ownership and control of the assets. All the same, that would not be worth all that much to Social Security participants were it not for the relatively high potential returns on equities. This explains why advocates of privatization attach such importance to calculations showing how even low- and middle-income workers would have a chance to accumulate wealth under their proposals.

High returns to equity and compound interest speak for themselves. Consider, for example, the eventual nest egg of the average earner if during a lifetime of work he or she were to invest in the U.S. stock market the 5 percentage points of the payroll tax that is to be set aside in a personal security account. At historical real rates of real return of 7.5 percent per year, the amount would grow to almost \$700,000 in 1997 dollars over a period of 40 years.<sup>14</sup> Even with a less adventuresome asset allocation, say, 63 percent equities and 37 percent fixed-income securities, which would mimic the typical corporate 401(k) plan, the amount would grow to almost \$400,000—still an enviable nest egg.<sup>15</sup> In either of these cases, the retirement income from the dedicated 5 percentage points would be many times more than the small basic payment to be made to Social Security beneficiaries at large.

Only the unlucky and the timid, the theory is, would have to rely on the basic payment for a significant share of retirement income. If they had to do so, however, they would draw benefits considerably smaller than they would receive under current arrangements. They are apt to be people with the least experience as investors—typically low-income workers with little or no prior savings, who also have the most to lose since Social Security is apt to be the major, if not the only, source of their retirement income. Significantly, the basic payment in the personal security accounts plan (which would start at \$410 per month in 1996 dollars for those with a full-career work history) is only about half the average benefit of new retirees today, among them many with much less than a lifetime of work. A meager guaranteed payment is unavoidable if as much as 5 percentage points of the tax rate is to be freed up for individual investment and if at the same time the system is to be brought into overall balance.

Even if lucky in their investment choices, many retirees would outlive their privatized Social Security assets, and so at some point in their lives they, too, would have to make do with benefits that would be considerably lower than under present arrangements. Consistent with its emphasis on choice in investments, the personal security accounts plan does not require annuitization—a boon to heirs, to be sure, but yet another source of risk to retirees who choose not to annuitize. Many presumably would choose not to, and with good reason. Annuitization is costly through private markets because of adverse selection; it is attractive to people who believe (often with inside information) that they will live longer than actuarial tables project, and thereby it is costly to everyone else.

Other personal financial planning would be affected by doing away with the essential feature of today's Social Security: defined benefits annuitized at retirement age. Able to count on such benefits, households can assume greater risk with their personal savings in order to build capital for retirement income beyond the rock-safe base a Social Security pension provides for most workers. If risk were introduced into the Social Security part of a retirement portfolio, the risk-return calculations on the rest of that portfolio perforce would also change. At least in part, the returns from privatization that even lucky investors would reap would be offset by lower returns from more risk-averse choices elsewhere in the portfolio.

Advisory and other investment service fees would also reduce the returns on privatized accounts. It would be politically awkward to prevent those who earn little to put their 5 percent into individually managed accounts—and, yet, it would be prohibitively expensive to service those accounts (imagine the complexity of servicing the small accounts of youngsters who work after school or during the summer). Even for privatized accounts of normal size, administrative costs would greatly exceed those Social Security incurs today. And they would exceed the costs that would be incurred by government were it to invest Social Security reserves in the stock market. That presumably would be done through index funds whose servicing fees would be no higher than, say, 25 basis points. Scale economies on amounts in the reaches of hundreds of billions of dollars could easily drive the cost even lower.

It would be hard to keep people from using the assets in their personal accounts for spending as meritorious, if not more so, than retirement. At the very least, it would be heavy-handed for policymakers to prohibit a 55-year-old man from using his “own” account to pay, for example, for a grandchild’s surgery, but to allow him to do whatever he chooses with the money when he reaches retirement age. The disabled, unless they had a strong taste for bequests, would be especially hurt by the restriction that personal security accounts not be tapped until retirement age. Those who become disabled would lose much of the income they could count on today, in exchange for the chance to build wealth for their heirs.

### **Political and Financial Risks of Privatization**

Advocates of privatization acknowledge the volatility of investment in private securities. But they emphasize that keeping Social Security largely as it is also entails risk in the form of political risk of program changes. Indeed, supposedly fixed benefits have turned out to be flexible whenever, as now, the long-run financial soundness of the system cannot be assured.

Timing risks associated with investment are significantly greater than the privatization advocates generally admit, however, judging by the long stretches of weakness in the stock market in the past. The case for allowing Social Security participants to invest in equities is appealing after 15 years of a virtually uninterrupted bull market, but it would not have gotten much of a hearing in 1978 after a decade of historically low real returns, which averaged minus 3 percent per year. And it would have seemed bizarre in the late 1940s and the 1950s when, despite the uptrend in the stock market, the memory of the 1929 collapse of share prices and the Great Depression was still fresh. Ironically, those would have been ideal times to embark on privatization from the point of view of subsequent returns; today, with stock prices at high levels, is perhaps the least appropriate of times. The slumping Japanese stock market of the 1990s, after years of speculative excess, provides yet another reminder of the risk of equity investment.

Privatization also involves political risks. The basic payment, which would have the stigma of “welfare” attached to it, would be vulnerable. And pressure to bail out the unlucky (with consequent damage to the long-run financial health of the system) would be intense, especially if there were a major downturn in the stock market affecting the retirement planning of large numbers of workers well up in age. There could well come a time, even if many years from now, when it would be necessary to reinvent today’s Social Security to “socialize” once again losses that realistically could not be borne privately.

The unlucky, to be sure, would be able to count on the basic payment and, presumably also, on modest returns even from disappointing investment choices. But a privatization system, by design, would not be in a position to supplement those amounts. The key role Social Security has played over the years in reducing poverty among the elderly, especially in the 1960s and 1970s when benefits rose sharply, would be undermined. Privatization would weaken the system’s goal of social adequacy, just as that is about to become more important than ever before.

It is not just the losers, moreover, who could wind up disappointed. Long-run equity returns of 7.5 percent per year in real terms (which came from growth rates in economic activity and in profits significantly above those that can be expected now and from an uptrend in price-earnings ratios) cannot confidently be extrapolated into the future (Baker 1997). For the 7.5 percent to hold, economic activity would have to advance more rapidly than the expected trend of 2.0 percent to 2.5 percent per year; profits would have to mount to implausibly high levels as a share of national income (and wages thus sink to implausibly low levels); or marketwide price-earnings ratios, which are now at record highs, would have to rise still further.

## **Financing the Transition**

Diverting 5 percentage points from the payroll tax to privately owned and managed accounts would make it impossible for Social Security to meet accumulated obligations without raising taxes significantly. The remaining 7.4 percent would have to fund pensions for retirees and the next generation of retirees (workers who retire in, say, the next 10 years)

and the other liabilities of the system, including liabilities to young workers whose contributions, while small thus far, could not be ignored. New monies—in the form of taxes or borrowing—would have to be raised for Social Security to meet all of these accrued obligations.

Ultimately, the transition problem of making good on existing commitments and financing privatized accounts at the same time will disappear. But “ultimately” promises to be a long time in any realistic scenario. Ahead would lie decades of Social Security taxes that are higher than they are now or of budget deficits that are higher than they otherwise would be. Young workers would be obliged to finance the pensions of their elders to hold up their end of the intergenerational bargain that otherwise would be in default. And they would also have to fund their own Social Security benefits, since there would be no generation behind them to make good on such a bargain. The personal security accounts plan, for example, would add 1.52 percentage points (to be paid only by the employee) to the 12.4 percent tax rate for the next 70 years. And, until about 2030, it also would borrow from the Treasury (and, in turn, from the public since Washington is unlikely to run budgetary surpluses). At the peak, borrowings would reach \$2 trillion (in constant 1996 dollars), which would increase outstanding debt held by the public by roughly half.

The borrowings would be repaid as transition costs retreat after 2030, but for decades they would complicate, if not encumber, federal finance. They would undermine the lending that Social Security, as now structured, is slated to provide to other functions of government in the next decade or so of demographic calm. And they would add to the strain Social Security will put on federal finance thereafter when the baby boom generation actually retires and past lending to the rest of government comes due.

All the while, other government activities—in a nation seemingly obsessed with deficits—would be under extraordinary new pressure to cut spending. Identifying activities considered nonessential is hard enough now. Even those who worry the loudest about deficit spending cannot present, let alone agree on, an adequately long list. It will be even more difficult to do so with the extra strain privatization would put on federal finance. The danger is not so much the associated rise in the



federal deficit, however problematic that would be, but the potential for the emasculation of essential functions of government.

Advocates contend that privatization would add to national saving, on the supposition that households would save more than they do now in response to the high returns to personal security accounts. The Chilean case is often invoked to make that point, although it is hardly relevant (see accompanying box). Households may well save less, believing that those accounts will supply more of their retirement income goal. How saving as a whole would be affected is not at all certain—except positively through the tax increase of 1.52 percent needed to make privatization viable.

### **Government as Investor in Equities**

Investing in private securities through government would obviate many of the problems inherent in privatization. Most important, that approach would minimize risk by sharing it. There would not be big losers, just as there would not be big winners. And, whatever the net returns overall turn out to be, they would be larger per dollar of investment because the investment advisory and other management fees would be appreciably lower. Indeed, potential returns on personal security accounts appear attractive not because private management of funds can claim to offer better returns than the market as a whole, but because the plan would have more “money” to direct to investment in risky securities (Jones 1996a).

Having government invest in the stock market is not problem-free, however. It would be hard to insulate such investment from political control. Tobacco stocks in an index fund, for example, would be at odds with federal efforts to curb smoking. Private nonprofit organizations routinely instruct investment managers to use increasingly detailed social screens to square their financial strategies with their missions. The temptation for government to do so would be hard to resist, certainly over the long haul. Government investment in private securities has always been viewed as “socialism through the back door” and rejected on those grounds rather than for any reason of risk.

Moreover, the increased returns Social Security would capture would be lost to other investors (Greenspan 1996). For the financial markets to

## Privatization in Chile: Not an Applicable Model

Although the Chilean experience with social security privatization has been a success in many ways, it was a response to problems very different from those this country faces. And it was a success in ways that either are unlikely to be replicated in the United States (e.g., bolstering the national saving rate other than by added taxes) or are irrelevant (e.g., fostering the development of capital markets).

Chile's social security system was in shambles by the mid 1970s. Payroll tax rates exceeded 25 percent. Benefits were only tangentially linked to lifetime earnings (which fostered a large underground economy and thus made for punishingly high tax rates for others). Administration was lax, governed all too often by political considerations. Rampant inflation destroyed the real value of reserves. The plan had to be repeatedly infused with general revenue (often plainly printing press money) in order to stay afloat, especially during the early 1970s, when the far left governed under President Allende.

Under the military government that deposed Allende, Chile opted for privatization, with broad freedom in asset choice. The plan is financed only by employees, who got a one-time pay hike of 18 percent in exchange for leaving employers out of the system. Covered employees' "contributions" (10 percent of earnings) are made to their accounts at an *administradora de fondos de pensiones*, a new financial intermediary not unlike the mutual fund in the United States. Government maintains a role only as provider of minimum benefits and regulator of the *administradoras*. Administrative costs, while extraordinarily high at the start, have come down to the neighborhood of 2 percent.

Large surpluses in the general fund (almost 8 percent of GDP at the peak in 1980) paved the way for smooth transition financing via "recognition bonds," redeemable at retirement and in the meantime lodged in privatized (but still mandatory) accounts. The surpluses, in turn, reflected proceeds from the sale of public enterprises—part of a broader shift in economic policy away from state socialism and toward private management and direction of the economy after the military took over. The pension deficit (stemming from the recognition bonds) was used to absorb the budgetary surpluses generated by the sale of public enterprises, preempting any move to reduce taxes or to increase government spending in response to the surpluses. Even at the height of transition financing, the consolidated central government deficit did not exceed 3 percent of GDP (Santamaria 1991). In this sense, privatization lifted national saving above what it otherwise would have been (The World Bank 1994). Dictatorship made it comparatively easy to put all of this into effect.

Returns from the privatized accounts have been impressive. This, however, probably reflects replacing state socialism with institutions of economic freedom (including developed capital markets) more than it reflects the advantages of privatization itself. Indeed, Chileans, through the *administradoras*, are still heavily invested (about 50 percent) in government paper.

clear, investors who would have chosen stocks over Treasuries would have to be persuaded to buy instead the Treasuries Social Security would forgo. At least in the first instance, returns on Treasuries would have to rise and those on private securities to fall. Investors as a whole (among them the Social Security trust funds) would be no better off. And they should not be, since such a switch of assets is unlikely to affect the productivity of capital and thus its returns. Returns under privatization would be similarly vulnerable to such a change in relative returns.

## **Fashioning a Consensus**

The maintenance of benefits approach, by its very nature, would right Social Security's long-run financial imbalance with minimal dislocation. Privatization would also remedy the problem, but Social Security would be changed, beyond recognition, in the process—a steep price to pay for the relatively high returns many, but certainly not all, participants would probably reap as a result. The high returns, moreover, are not all that persuasive, given the opportunity to achieve the same returns by having government do the investing. Where the investment risk should be lodged, and thus the distribution of those returns, is the key issue. That is as much an issue of values as it is of economics.

If, after full national discussion, the choice is to keep Social Security much as it is today, reaching agreement on specifically what benefits to cut and what taxes to raise will not be easy. It will be less hard, however, if the changes proposed evoke a sense of shared responsibility for restoring the system's long-run financial balance. Workers to retire in the next 10 or 15 years could be expected to buy into a plan that would assure their pensions long into the future, even if at the cost of modest reduction in benefits. Low- and moderate-income workers, young as well as old, would likely accept reductions in benefits if they see the reductions as a way of guaranteeing the kind of base level of income support Social Security has traditionally provided.

Adding to the saving incentives in the tax code—in effect, moving away from taxation of income and toward taxation of consumption—would make changes to Social Security taxes and benefits easier to accept. New incentives for saving would graft a variant of privatization onto the

system—one that would give more promise of spurring national saving than simply shifting the assets of Social Security participants from government to private securities. Such an approach, moreover, would have none of the downside of privatization: the risk, the dirigisme in the use of what would become one's own money, the redistribution of income to the swift. Saving incentives would have essentially the same effect as the Gramlich plan or any other dedication of a relatively small increase in Social Security taxes to individual accounts, but they would not have the compulsory character.

High-income taxpayers would find it easier to accept making the system more progressive (for example, by using different percentage factors in the calculation of benefits) if, at the same time, they were given the opportunity to make larger contributions to 401(k), IRA, and other tax-deferred savings plans. Such a combination would protect the pensions of low- and moderate-income workers, while offering a reduction in taxes that would move the tax system more toward neutrality between saving and consumption, which would be a plus in its own right. Young workers at all income levels would find it easier to accept further slip-page in the implicit returns on their Social Security taxes if, at the same time, they could more easily build a supplementary retirement nest egg. They would be among those to profit most from tax-deferred income, on the axiom that taxes deferred are taxes never paid.

Casting the net wide in other ways is also in order. The Canadian “double-decker” model, in particular, ought to get a sympathetic hearing. General taxation finances a flat payment made to all beneficiaries (which is now means-tested); payroll taxes finance an added payment, which is tied to lifetime earnings. While the particulars that would make sense in the United States may differ, the principle that Social Security's income-support function be financed broadly across the economy, and not by a regressive tax on labor, applies. And so does the principle of financing the individual equity function through earmarked payroll taxes (although it is better to levy them only on employees in order to minimize any distortion in the price of labor).

Building a new measure of flexibility into Social Security benefits formulas—by, for example, linking ongoing as well as initial benefits to prevailing wages—also ought to be considered. Beneficiaries would

reap some extra income if productivity were to rise more than expected (an outcome, by the way, they would have helped lay the groundwork for during their working years). If, instead, the economy's performance were to be disappointing, retirees would share in the shortfall (this, too, on the premise that "all are in the same boat"). Because it would be automatic, adjusting pensions to the actual performance of the economy would avoid the troublesome income distribution issues the nation must now confront. It would redress Social Security's inadequacy as a means of reducing poverty among the old-old. It would involve less measurement difficulty than linking benefits to inflation. And it would promote the sense of shared responsibility that is needed for a consensus to emerge on how to adapt Social Security to new circumstances.

Such an action would, it is true, raise system costs because real wages rise with productivity. But other changes to benefits formulas could be made to offset such a rise. Benefits could be lowered early in retirement when personal savings and other sources of retirement income can readily be called on in most cases. Replacement rates are hardly immutable, judging by the system's history.

Even if existing benefits remain linked to the price level, consideration should be given to shifting the pattern of benefits forward. If Social Security can be made a fair annuity for someone retiring at any age between 62 and 70, it can be made no less fair by skewing the distribution of the same lifetime benefit to the later years. In any case, the high poverty rate of the old-old cautions against arbitrary reduction in cost-of-living escalation based on broad-brush estimates of how much inflation is overstated.

## **The Essence of the Challenge**

It is important in the debate on Social Security's future that the nation not lose sight of the underlying problem the coming demographics present: an uncommonly large transfer of *real* resources from the working to the retired population. This is in the offing, by whatever means the baby boom's Social Security benefits are financed, however much the baby boom saves independently for its retirement, and however much the economy grows in the meantime.

This broader perspective counsels not just stepped-up saving and investment, but investment—presumably most of it in the public sector because of the time horizon—that will yield dividends long into the future. Long-lived public capital can do a lot to ease the transfer of resources across generations of markedly different size.

Increased labor force participation by people reaching retirement age would also help (Levy 1995). There is little to be gained, and much to be lost, by having loss of Social Security benefits touched off by low ceilings on earnings (currently \$13,500 per year). However appropriate those ceilings may have been in the past, they are much less so today. With the baby boom generation's retirement on the horizon, the nation can ill afford incentives to shelve human capital prematurely, even if its productivity has slipped from peak levels.

Finally, serious attention has to be given to reducing the nation's current account deficit. The transfer abroad of command over resources that ever-growing external indebtedness points to cannot but make the transfer of resources across generations of markedly different size all the more difficult.

## Notes

1. Section 706 of the Social Security Act requires the secretary of health and human services to appoint an advisory council every four years to review the long-run financial outlook of the trust funds under the Social Security umbrella and to make recommendations on how best to prepare the programs for the future. The council was composed of 13 members, including the chairman, representing the general public, workers, business, and the self-employed.
2. The 2.2 percent is the difference between the 75-year cost rate and income rate, based on the intermediate-cost assumptions for wages, interest rates, life expectancy, and other key variables. The high-cost assumptions generate an imbalance as large as 5.5 percent; the low-cost assumptions, a surplus of 0.2 percent.
3. This is true in the abstract, although the cutbacks in benefits and other proposed measures, the six council members point out, would raise net revenue enough to allow the Social Security trust funds both to invest in equities and to buy as much of the Treasury's offerings as it would under current law.
4. After-tax replacement rates are higher for low- and average-wage workers since for the most part their Social Security benefits are not taxed.

5. Technically, Social Security is off budget, but its surplus or deficit is counted against budget targets.
6. Disability benefits were not included in the analysis because of the paucity of detailed data on recipients of past benefits and the uncertainty about future benefits.
7. Projections based on the 1983 reforms, which were intended to achieve long-term financial balance, have gone far off course for several reasons. Among the most important are the simple passage of time puts the system into greater deficit (surplus years near term get replaced by deficit years further out in time); the economic assumptions for such things as real wages were lowered; disability payments turned out to be considerably higher than expected. The time problem remains, but past estimating errors are no indication that today's projections will also go far off course.
8. Most of the group lined up behind increasing payroll taxes as well, but not until near the middle of the next century, when the passage of time will have rendered today's proposals inadequate to maintain balance.
9. The revenue would be re-booked starting in 2010, by which time, the assumption is, the refinancing of Medicare will be in effect.
10. The income taxes paid on the payroll taxes of employees points up the even broader linkage between Social Security and federal finance as a whole. The revenue from payroll taxes has always been credited to the general fund, but it could just as well have been credited to OASDI.
11. Alternatively, a rise in payroll taxes of 0.15 percentage points for both employer and employee would provide the same effect on the long-run deficit. Although viewed as preferable to a further raising of the retirement age—which was rejected by all but one of the maintenance of benefits group—the alternative tax proposal conflicts with the group's general rejection of increasing payroll taxes to close the long-term funding gap.
12. Reflecting the trend toward forced early retirement, the labor force participation rate of men between the ages of 55 and 64 is now 67 percent, compared with 85 percent in the mid 1960s.
13. The recently enacted Kennedy-Kassebaum legislation levels the playing field, but not fully until 2006.
14. The calculation is based on Ibbotson Associates data for the period 1926 to 1996.
15. In violation of the principle of diversification of assets (among them human as well as financial capital), roughly half of the equity holdings of the 1,000 largest 401(k) plans are in own-company stock (*Pensions & Investments* 1997, 34). Nonequity holdings are dominated by GICs (guaranteed investment contracts), a close cousin to long-term CDs. Fixed-income assets are projected to return 2.5 percent per year in real terms, in line with the trend from 1926 to 1996 as calculated by Ibbotson Associates.

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